

August 11, 2009

## Lloyd's

**Primary Credit Analyst:**

Peter Grant, London (44) 20-7176-7086; peter\_grant@standardandpoors.com

**Secondary Credit Analyst:**

Rob Jones, London (44) 20-7176-7041; rob\_jones@standardandpoors.com

### Table Of Contents

---

Major Rating Factors

Rationale

Outlook

Corporate Profile: Significant Participant In Worldwide Markets

Competitive Position: Strong, And Improving, With A Unique Brand

Management And Corporate Strategy: Strategic Review Underway, But Fundamental Changes Are Not Anticipated

Enterprise Risk Management: Continuous Enhancement Remains A Key Priority For Lloyd's

Accounting: Various Accounting Conventions Considered

Operating Performance: Resilient Headline Numbers Obscure Some Underlying Deterioration

Investments: Conservative Investment Stance Pays Off

Liquidity: Remains Strong

Capitalization: Strong And Highly Resilient

## Table Of Contents (cont.)

---

Financial Flexibility: Diversity Of Capital Providers Positively  
Differentiates Lloyd's

# Lloyd's

## Major Rating Factors

### Strengths:

- Strong competitive position
- Strong operating performance
- Strong capitalization
- Strong financial flexibility

### Weaknesses:

- Relatively high reinsurance reliance
- Inherent operating performance volatility

### Operating Company Covered By This Report

#### Financial Strength Rating

Local Currency

A+/Stable/--

## Rationale

The insurer financial strength rating on the Lloyd's insurance market (Lloyd's or the Market) reflects Lloyd's strong competitive position, strong operating performance, strong capitalization, and strong financial flexibility. These positive factors are partly offset, however, by relatively high reinsurance reliance and the inherent potential for operating performance volatility.

Lloyd's competitive position is strong, supported by the positive attributes associated with its unique brand, attraction as the world's largest subscription market, London's continued position as a major international insurance and reinsurance market, and policyholder loyalty. In our view, the impressive level of resilience that Lloyd's has demonstrated to the events of the past 12 months further reinforces its attractiveness as an operating platform.

Standard & Poor's Ratings Services expects Lloyd's prospective operating performance to remain strong overall, although unlikely to return to the peak levels seen in 2006/2007 for the foreseeable future. The Market posted a pretax profit of £1.9 billion for 2008 (2007: £3.8 billion) at a calendar year combined ratio of 91.3%. In our view, this represents a very strong level of performance in an extremely challenging operating environment. The £1.4 billion of net losses incurred by the Market in respect of Hurricanes Gustav and Ike were largely offset by the £1.3 billion of releases on prior year loss reserves. Lloyd's investment return was materially weakened by the extreme volatility seen in global financial markets during 2008. As a consequence, Lloyd's produced a total investment return of £1.0 billion, less than half the level of the prior year. Nonetheless, the Market's total investment return for the year at 2.5% (on a full mark-to-market basis) still represents significant outperformance relative to many of its peers. Our improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels recorded prior to 2002. Nevertheless, earnings volatility will remain a feature given the nature of the specialty business lines that continue to represent Lloyd's core business.

Capitalization is strong, supported by strong and improved capital adequacy and the expected continued efficacy of capital-setting processes. While Standard & Poor's expects that substantial positive reserve movements will remain a feature of the Market's performance in 2009, we do not expect these to be a material driver of the overall result beyond 2010. Relatively high reliance on reinsurance remains a detraction.

Lloyd's financial flexibility is strong, being principally derived from capital providers' continued support. The diversity of Lloyd's capital providers represents a unique strength for the Market, particularly in the current environment where most (re)insurers are facing significant uncertainty in respect of their ability to raise capital should the need arise. Our view of Lloyd's financial flexibility is also reinforced by the recent completion of Phase II of Equitas' \$7 billion reinsurance deal with National Indemnity Co. (NICO; AAA/Negative/--), the declining trend of annual undertakings given to insolvent members, and the positive momentum that continues to surround the Market, which makes Lloyd's an attractive platform for an increasingly diverse range of capital providers.

## Outlook

The stable outlook reflects Standard & Poor's expectations that:

- Subject to a normalized level of catastrophe loss experience (that is, below 10% of net premiums earned), Lloyd's will maintain its accident year combined ratio below 95% and its return on revenue (ROR) above 10%.
- Lloyd's main capital providers will remain committed to the Market.
- There will be further improvement in the London market's administrative processes.
- Capital adequacy will remain strong, as reflected in central assets available for solvency purposes remaining above £1.75 billion and Lloyd's solvency ratio remaining at more than 300%.
- Operating performance of the continuing Market will not be materially hindered by future net deterioration in technical reserves.

An outlook revision to positive would depend on Lloyd's continuing to exceed our expectations over a sustained period. An outlook revision to negative is increasingly unlikely, but would probably be driven either by operating performance returning to levels seen prior to 2002, reflecting poor management of a softening underwriting cycle, or by the incurrence of a loss outside the Market's risk tolerance.

## Corporate Profile: Significant Participant In Worldwide Markets

The London-based Lloyd's insurance market is a significant participant in insurance and reinsurance markets worldwide. Lloyd's wrote gross premiums in 2008 of £18.0 billion across a diverse range of classes, predominantly via broker distribution (see Table 1).

**Table 1**

	--2008--		--2007--		--2006--		--2005--	
	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)	(Mil. £)	(%)
Reinsurance	6,299	35.0	5,455	33.3	5,560	33.8	5,243	35.0
Casualty	3,762	20.9	3,364	20.6	3,572	21.8	3,402	22.7
Property	3,971	22.1	3,809	23.3	3,638	22.2	3,199	21.3
Marine	1,334	7.4	1,226	7.5	1,153	7.0	1,017	6.8
Energy	1,150	6.4	1,019	6.2	1,125	6.9	804	5.4
Motor	939	5.2	983	6.0	923	5.6	895	6.0
Aviation	481	2.7	464	2.8	393	2.4	375	2.5
Life	49	0.3	46	0.3	50	0.3	47	0.3

**Table 1**

Lloyd's/Main Business Classes By Gross Premiums Written (cont.)								
Total	17,985	100.0	16,366	100.0	16,414	100	14,982	100

As at Jan. 1, 2009, there were 78 syndicates (including four special purpose syndicates) trading at Lloyd's, supported by 49 managing agencies and sourcing business from 176 Lloyd's brokers. These figures exclude those managing agents and syndicates that are only authorized to underwrite reinsurance to close (RITC) contracts.

Lloyd's has very wide geographic coverage, with specific trading rights to write insurance business in 80 countries and the ability to write reinsurance in many more. Nevertheless, a significant majority of income (66% in 2008) continues to be sourced from North America and the U.K.

## Competitive Position: Strong, And Improving, With A Unique Brand

Lloyd's competitive position is strong, supported by its unique brand, attraction as the world's largest subscription market, London's continued position as a major international insurance/reinsurance market, and policyholder loyalty. The Market's already strong competitive position has been further enhanced in recent years by a combination of the successful completion of Equitas' deal with NICO, as well as improving London market business processes. The attractiveness of Lloyd's as an operating platform is evidenced by the significant increase in the number of new entrants to the Market over the past 24 months either directly or through the acquisition of an existing operation.

Lloyd's draws significant competitive strength from its unique brand. Built over centuries, the brand is recognized globally and is often viewed as a key positive attribute among insurance buyers. Although the brand may not regain the position it had before the Market's near demise during the mid-1990s, Lloyd's underwriters are still recognized as possessing a number of positive traits. These include an enviable track record of timely settlement, particularly following major loss events, and their willingness and ability to offer innovative underwriting solutions to their clients. In our view, the impressive level of resilience shown by Lloyd's to the extremely challenging economic environment over the past year will further underpin its competitive position.

Lloyd's is the world's largest subscription insurance market. Although its managing agents operate as independent businesses, the size and diversity of underwriting capacity the Market can potentially provide allows it to compete robustly with the largest global insurance groups. The diversity of the providers of capacity to Lloyd's, and the enhanced financial flexibility this affords the Market relative to many of its peers, would likely become a key competitive advantage for Lloyd's were a market-changing loss event to occur in the near future.

The London market and Lloyd's have maintained their critical mass of relevant underwriting, broking expertise, and support services, remaining the "natural" home of diverse specialist underwriting niches, such as marine, energy, aviation, and certain nonmarine classes. Significant policyholder loyalty results in attractive business continuing its historical flow to London, enticing capital to support and sustain the Market. This is despite intense competition from other international insurance markets, particularly Bermuda. Further, in recent years there has also been an increased propensity for risks that might otherwise have found their way to London "sticking" within regional markets. Lloyd's has been proactive in its response to this emerging threat by further extending and, where necessary reinforcing, its global reach. Standard & Poor's expects this will remain a priority for the market over the medium term.

The features of business typically underwritten at Lloyd's include: complexity; large monetary exposure levels; and a high-severity, low-frequency profile of risk. The resultant underwriting portfolio, although diverse, is positioned toward a highly credit-sensitive clientele. A significant majority of Lloyd's income is sourced from the U.S. and the U.K., which are particularly credit-sensitive markets compared with those in Continental Europe. Lloyd's also predominantly sources its business through brokers--the most credit-sensitive distribution channel--and remains highly dependent on the top three large international broking groups.

Owing to the credit-sensitive nature of its key stakeholders, confidence in Lloyd's among these constituencies is extremely important, hence the value placed by Standard & Poor's on the deal concluded between Equitas and NICO in 2006. Phase II of the NICO transaction was completed effective June 30, 2009. As a result, Equitas and relevant policyholders now benefit from the full \$7 billion of reinsurance cover provided under this arrangement (in addition to Equitas' reserves). The U.K. High Court approved the insurance business transfer of the members' liabilities in respect of 1992 and prior non-life business written at Lloyd's to Equitas Insurance Limited, a newly formed FSA authorized insurance company within the Equitas Group. This transfer relieves the members and former members concerned from those liabilities under English law and the law of every other state within the EEA. Standard & Poor's believes the Equitas/NICO deal renders as highly remote the potential for reserve inadequacy at Equitas to undermine confidence in Lloyd's at some point in the future, thereby damaging the Market's competitive position.

The London market's business administrative processes have historically been a drag on Lloyd's competitive position. In being less efficient than those of global market peers, they reduced London's relative attractiveness to policyholders in terms of service quality and cost. Since 2006, Lloyd's has embarked on a fairly ambitious business process reform agenda. This has maintained its momentum, and is bringing tangible benefits to clients and market participants alike. The progress made by Lloyd's in this area is demonstrated by the fact that continued business process reform and enhancement is now viewed by the Corporation to be "business as usual". Nonetheless, having established its credentials, Standard & Poor's expects the Market Operations team will continue to actively pursue its agenda with an emphasis on removing the residual frictional costs associated with trading at Lloyd's. Future initiatives are expected to be framed in consultation with key stakeholders and subjected to a robust cost/benefit analysis.

## Management And Corporate Strategy: Strategic Review Underway, But Fundamental Changes Are Not Anticipated

### Management

The quality of the Market's management (at the Lloyd's Corporation and managing agent levels) has improved to a point where it is more supportive of a stronger, less volatile prospective earnings profile. This can be attributed both to the Corporation infrastructure, which has proved to be a positive influence on Lloyd's, and the improved quality of management within individual managing agents.

The Corporation has established a credible track record in relation to its prime goal of protecting the Lloyd's franchise. This has been achieved through its experienced staff and the development of increasingly robust performance, risk-monitoring processes, tools, and benchmarks against which managing agents are assessed. Part of the credit for the enhanced effectiveness of the Corporation in positively influencing Market behavior must, in our view, be attributed to the Franchise Performance Directorate (FPD). Rolf Tolle, who has led the FPD from its

inception, will retire at the end of 2009 and will be replaced by Tom Bolt. This change in leadership will coincide with a challenging operating environment, which we believe presents some execution risk. Nonetheless, we expect the FPD to maintain its impressive track record under its new leadership.

Despite its improved effectiveness, the Corporation's remit remains somewhat limited. It can take necessary action to protect the Central Fund, Lloyd's reputation, brand, and ratings--hence, for example, the introduction from 2007 of underwriting, claims, and risk management principles and minimum standards. Nevertheless, while considering the above, the Corporation is constrained from promoting or undertaking activity that could be considered anti-competitive. In addition, it is understood that the Corporation is not expected to be a micromanager of managing agents, therefore the oversight it provides is designed to be robust without being overbearing.

As expected within a marketplace, the quality and sophistication of management varies. Nevertheless, there has been an improvement in the general quality of managing agents' management. The teams in place at most managing agents can be credited with successfully steering their businesses through the last soft market. As a result, generally they either already have the skills to manage underwriting cycles or will have gained valuable experience that we believe will leave them well positioned to cope with the demands of today's challenging operating environment.

### Strategy

Lloyd's has recently initiated a strategic review, the results of which will be delivered in early 2010. The review is focused on ensuring that the Market is optimally positioned both to capitalize on recent substantial changes seen in the competitive environment, and to respond to exogenous factors including shifts in the regulatory and fiscal landscape. In addition, the review will look at geographic and product diversity. In recent years, the Market has increasingly focused on more volatile specialty lines business partly as a result of the exit of less volatile personal lines and retail operations.

Lloyd's continues to make significant progress toward the successful achievement of its existing strategic priorities. The Corporation remains focused on realizing the "Optimal Platform" concept within the medium term, which, if achieved, would result in Lloyd's being more attractive to clients, brokers, and capital providers alike. The successful achievement of the Optimal Platform is increasingly important if the Market's long-term competitive position is to be protected in light of the attractions offered by other international insurance and reinsurance markets.

The Optimal Platform seeks to deliver five clear benefits--namely, a clear and transparent performance management framework, capital advantages, a secure and highly rated market, cost-effective and easy access to the world's major markets, and efficient business processes. The first three of these objectives have been broadly delivered, but a strong focus on the last two of these objectives is expected to remain for the foreseeable future.

Despite the progress made to date, in Standard & Poor's opinion the achievement of the Optimal Platform remains challenging. Matters are helped by the franchise business model, which can be used to facilitate required change and the experience of Lloyd's CEO, Richard Ward, with regard to improving the efficiency and profitability of exchanges. Nonetheless, the success of future business process enhancements will largely be determined by the support they receive from Lloyd's largest, most influential managing agents.

## Enterprise Risk Management: Continuous Enhancement Remains A Key Priority For Lloyd's

Standard & Poor's considers the quality of the Market's enterprise risk management (ERM) to be adequate, which is supportive of the rating. ERM is of high importance. The Market operates in numerous complex business lines, many of which have the potential to demonstrate extreme volatility. Individual syndicates have historically performed with significantly varying degrees of success.

Centrally, Lloyd's continues to make considerable progress on ERM and further enhancements are planned. Key initiatives over the past 12 months have included the more timely, thorough, and cohesive reporting of the strategic risks faced at the Corporation and/or Market level. Standard & Poor's has also been impressed by the speed of the Corporation's response to emerging risks over the past year. For example, in the wake of the collapse of Lehman Brothers, Lloyd's undertook a proactive and thorough evaluation of the potential liquidity risk posed to the Market in the event of the insolvency of one of its key custodian banks. Nevertheless, in our view uncertainty over the relative ERM capabilities evident among managing agents continues to constrain the overall ERM assessment on the market as a whole.

Risk management culture is adequate and improving, reflecting the greater focus on risk management at Lloyd's centrally. The embedding of a strong risk management culture at the Corporation is reinforced by a clear link between each employee's achievement of their risk management objectives and their overall performance evaluation. While the Corporation seeks to perform its duties in a facilitative manner, it has the option to adopt a more prescriptive approach as and when necessary. As an example, where a syndicate is unable to demonstrate its compliance with all aspects of the minimum standards, the Corporation will often begin by agreeing a plan for corrective action to be taken. If the syndicate fails to meet the Corporation's expectations in terms of the implementation of this plan then its prospective business plans are likely to be subjected to even greater scrutiny. In addition, its Individual Capital Assessment (ICA) may be loaded to reflect the incremental threat this operation is perceived to pose to the central fund.

Catastrophe risk appetite at the centre is expressed in terms of exposure to deterministic realistic disaster scenarios (RDS). These RDS were developed by Lloyd's, but are used by many (re)insurers worldwide.

Risk controls are adequate, but the market structure dictates that their implementation is decentralized.

Underwriting risk controls are adequate, but the capabilities of individual managing agents are varied. The underwriting management principles and minimum standards have been successfully implemented and are expected to be further refined and enhanced over the medium term. During 2008, a project was successfully delivered that will improve the granularity of the underwriting data the FPD is able to access for monitoring purposes. Standard & Poor's believes this project will further enhance FPD's ability to oversee the market's underwriting performance at a critical juncture. Proactive cycle management is expected to remain a key focus both for Lloyd's and our rating on the Market over the medium term.

Catastrophe risk-related risk controls are adequate. The Corporation seeks to ensure there are appropriate levels of cat risk aggregation control both within each managing agent and at the Market level, primarily using the RDS framework. Recent industrywide loss experience, particularly in respect of Hurricane Ike, once again highlighted the extent of the model risk inherent in managing the level of exposure to natural catastrophes in peak zones. This risk appears to increase the larger and more idiosyncratic the event in question. Given Lloyd's business profile, we believe that the Market remains relatively more exposed to this inherent model risk than its peers. This risk is partially mitigated by the diversity of approaches to catastrophe modelling employed throughout the Market, which

is actively encouraged by the Corporation via the minimum standards.

Reserve risk-related controls are adequate. Reserve integrity at the managing agent level has benefited from the requirement for all syndicates to obtain independent actuarial certification of their reserves and Corporation oversight. The inherent reserving risk faced by the Market has diminished considerably in recent years both as a consequence of the completion of the NICO transaction, and a persistent reduction in both the number of run-off years of account and the magnitude of the undertakings given to insolvent members. Nevertheless, Standard & Poor's expects the more challenging operating environment to preface an uplift in reserving risk over the medium term.

The Corporation performs continuous, centrally coordinated, and holistic reviews of its managing agents across all areas of risk using the ICA submissions and RDS as key inputs. The centre has operated a Market-level stochastic model for a decade. Having been progressively enhanced, and now built on syndicate ICA inputs, it forms a key part of the capital adequacy dialogue with the U.K. Financial Services Authority.

The market structure, and competition law, dictate that the Corporation cannot directly intervene to ensure the actions taken by individual managing agents enable the Market to optimize its risk-adjusted return on capital (RAROC). This continues to be a somewhat constraining factor for our assessment of the Market's strategic risk management capabilities, which are considered adequate overall. However, some of the Market's participants exhibit strong strategic risk management in their own right and we expect this group to expand in the future.

Emerging risk management is considered strong. Lloyd's is at the leading edge of a number of initiatives (for example, Lighthill Risk Network and Climatewise) that are focused on the identification, and management, of emerging risks. Increasingly, Lloyd's is looking to draw on the research of leading academics and/or scientists in assessing the risk implications of emerging issues. A comprehensive database of emerging risks is maintained. This stores information in respect of approximately 240 individual risks and is used to produce a report that is regularly reviewed by Lloyd's Risk Committee. In addition, there is increasing interaction between the Emerging Risks Team and other parts of the Corporation.

## Accounting: Various Accounting Conventions Considered

Standard & Poor's analysis of Lloyd's relies on data provided under a number of accounting conventions, including fully audited three-year fund and U.K. generally accepted accounting principles (GAAP) accounting for syndicates, and unaudited pro forma financial statements for the Market. The latter, while externally reviewed, are unaudited and are generated to present Lloyd's aggregated results on a basis that is broadly comparable with results for general insurance companies.

The key adjustments made within Standard & Poor's risk-based capital model from published financial statements are:

- Recognition of loss-reserve discount; and
- Full hybrid equity credit given to the subordinated loan notes and perpetual subordinated capital securities issued by The Society of Lloyd's (A+/Stable/--) in 2004 and 2007, respectively.

## Operating Performance: Resilient Headline Numbers Obscure Some Underlying Deterioration

Table 2

Lloyd's/Operating Performance							
(Mil. £)	2008	2007	2006	2005	2004*	2003	2002
Total gross premiums written	17,985	16,366	16,414	14,982	14,614	16,422	16,203
Annual change (%)	9.9	(0.3)	9.6	2.5	(11.0)	1.4	0.6
Total net premiums written	14,217	13,256	13,201	11,770	11,734	12,250	11,160
Annual change (%)	7.2	0.4	12.2	0.3	(4.2)	9.8	0.8
Total revenue <sup>¶</sup>	14,339	14,320	13,645	12,490	12,329	12,156	11,313
Annual change (%)	0.1	4.9	9.2	1.3	1.4	7.5	7.5
Profit before tax	1,899	3,846	3,662	(103)	1,367	1,892	834
Annual change (%)	(50.6)	5.0	(3655.3)	(107.5)	(27.7)	126.9	(126.8)
Cumulative profit before tax post 2000	9,076	7,177	3,331	(331)	(228)	(1,595)	(3,487)
ROR*§ (%)	12.1	23.2	22.7	(5.5)	7.5	12.6	7.0
Net loss ratio (%)	61.4	50.0	49.0	80.7	64.8	57.2	62.3
Net expense ratio (%)	29.9	34.0	34.1	31.1	31.8	33.5	36.3
Net combined ratio (%)	91.3	84.0	83.1	111.8	96.6	90.7	98.6
Accident-year combined ratio (%)	100.5	90.5	85.2	111.9	93.5	85.7	89.0

\*Restated. <sup>¶</sup>Net premiums earned plus allocated investment income. <sup>§</sup>Balance on the technical account for general business/total revenue N.A.--Not available.

Lloyd's prospective operating performance is expected to remain strong overall, but it is facing some headwinds that we believe make it unlikely that the Market's profitability will return to the peak levels seen in 2006/2007 for the foreseeable future.

The Market posted a pretax profit of £1.9 billion for 2008 (2007: £3.8 billion) at a calendar year combined ratio of 91.3%. In our view, this represents a very strong level of performance in an extremely challenging operating environment. The £1.4 billion of net losses incurred by the Market in respect of Hurricanes Gustav and Ike were largely offset by the £1.3 billion of releases on prior year loss reserves. Lloyd's investment return was materially hampered by the extreme volatility seen in global financial markets during 2008. As a consequence, Lloyd's produced a total investment return of £1.0 billion, less than half the level of the prior year. Nonetheless, the Market's total investment return for the year at 2.5% (on a full mark-to-market basis) still represents significant outperformance relative to many of its peers.

Foreign exchange gains also had a material impact on the Market's performance in 2008, primarily as a result of the decline in the value of the British pound sterling against the U.S. dollar. The Market posted a £0.4 billion gain on nonmonetary items that were not retranslated using the year-end exchange rate. The vast majority of this item, which reduced the combined ratio by 3.0 percentage points, is expected to reverse during 2009.

In Standard & Poor's opinion, the Market's accident year combined ratio for 2008, when normalized for "excess" cat losses vis-à-vis the long-term average and extraordinary foreign currency effects, provides the most appropriate basis for projecting the Market's future underwriting performance. The table provided below details the impact of the relevant adjustments we have made in our analysis:

**Table 3**

<b>Adjustments In Our Analysis</b>	
<b>(%)</b>	
Headline combined ratio	91.3
Add: Impact of releases from prior year loss reserves	9.2
Unadjusted accident year combined ratio	100.5
Add: Abnormal fx gain on non-monetary items	3.0
Less: Excess cat losses versus long-term average	(5.7)
Adjusted accident year combined ratio	97.8

This analysis suggests that the Market will need to push through substantial average rate increases if it is to exceed our long-range expectation for the accident year combined ratio of 95% in 2009. Based on the evidence to date, we believe this is a realistic possibility given that Lloyd's portfolio is heavily weighted toward the classes of business that have seen the most substantial rate increases thus far, namely U.S. cat exposed Reinsurance and Energy.

Implicit within our analysis is an expectation that the impact of prior year reserve releases on the Market's overall performance will slow markedly beyond 2009. This, when coupled with materially lower forecast investment returns, is expected to represent a relative drag on the Market's earnings over the rating horizon.

Our improved view of management control within the Market underpins a belief that performance will not be allowed to return to the levels recorded prior to 2002. Nevertheless, earnings volatility will remain a feature given the nature of the specialty business lines that continue to represent Lloyd's core business. The efficacy of Lloyd's cycle management is expected to be an increasingly key driver of its earnings in the longer term.

## Investments: Conservative Investment Stance Pays Off

**Table 4**

<b>Lloyd's/Investment Split</b>							
<b>(%)</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004*</b>	<b>2003</b>	<b>2002</b>
Bonds and other fixed-interest securities¶	57	56	55	58	54	78	78
Equities and other variable-interest securities	10	12	11	8	10	7	5
Cash and bank deposits	21	20	23	23	30	12	12
Loans and private placements	12	12	12	11	6	3	3
Other investments	0	0	0	0	0	0	1
Total investments	100	100	100	100	100	100	100

\*Restated. ¶Pre-2004 includes members' funds at Lloyd's.

Lloyd's investments are very strong. The Market has historically pursued a relatively conservative investment strategy, and this has partially insulated it from the extreme volatility seen in global financial markets over the past 18 months. This is demonstrated by the fact the Market produced a positive overall investment return of 2.5% for 2008 (2007: 5.6%) on a full mark-to-market basis. Many of Lloyd's peers produced negative overall returns, some materially so. The inherent conservatism of Lloyd's investment strategy insulated its capital position from the volatility seen during 2008, but will also constrain its investment income going forward.

Trust funds are primarily invested in either cash or high-quality, highly liquid fixed-income securities. The

investment portfolio is of short duration, broadly matching the profile of liabilities.

The Central Fund's investment policy has always been somewhat more aggressive than that of managing agents, with 12% of investments held in equities and hedge funds at Dec. 31, 2008 (15% at Dec. 31, 2007). Given the intended long-term nature of the Central Fund, this approach is understandable. Standard & Poor's expects that the Central Fund investment stance will remain prudent overall.

## Liquidity: Remains Strong

Lloyd's liquidity is strong, supported by a substantial cash position, high-quality bond portfolio, consistently positive operational cash flow, and substantial credit facilities in place to support short-term liquidity requirements.

Liquid asset coverage of technical reserves remained robust in 2008 at 124% (132% in 2007), and is expected to remain comfortably in excess of 100%.

U.S. situs trust funding requirements place an additional burden on the Market's liquidity and financial flexibility.

## Capitalization: Strong And Highly Resilient

Capitalization is strong, supported by strong and improved capital adequacy and the expected continued efficacy of capital-setting processes. In the short term, Standard & Poor's expects the continuing Market to report diminishing, but in aggregate still positive, reserve movements. Continuing relatively high reliance on reinsurance, however, remains a detraction.

### Capital adequacy

Lloyd's capital adequacy remains strong, having proven its resilience over the past 18 months. Capital shows relatively low reliance on reserve discount, deferred acquisition costs, and hybrid equity.

The resilience of Lloyd's capital adequacy is demonstrated by various measures. These include the level of central assets for solvency purposes--£2.6 billion at year-end 2008 (2007: £2.5 billion), which is well ahead of Standard & Poor's expectation of about £1.75 billion--and Lloyd's solvency ratio, which remains well in excess of 1,000% at year-end 2008--considerably above our 300% target.

Management action is expected to support continuing strong Market capital adequacy, the Corporation maintaining capital levels reasonably above the regulatory minimum (currently 35% higher at member level considering also the uplift provided by central assets), to meet Optimal Platform objectives.

### Loss reserves

**Table 5**

Lloyd's/Reserving Track Record*							
(%)	2008	2007	2006	2005	2004†	2003	2002
Calendar-year net combined ratio	91.3	84.0	83.1	111.8	96.0	90.4	94.9
Accident-year combined ratio	100.5	90.5	85.2	111.9	93.5	85.7	89.0
Prior-year reserve movement combined ratio points	(9.2)	(6.5)	(2.1)	(0.1)	2.5	4.7	5.9
Run-off years' reserve movements (mil. £)	39	(48)	(3)	(325)	(350)	(329)	N.A.
Continuing Market reserve movements (mil. £)	1,226	904	273	339	48	(343)	N.A.

**Table 5****Lloyd's/Reserving Track Record\* (cont.)**

\*Data on pro forma annual accounting basis. †Restated. N.A.--Not available.

During 2008, releases on prior-year loss reserves accounted for £1.3 billion, or more than 65%, of the Market's net profit after tax. In the short term, Standard & Poor's expects such releases to diminish but persist for the continuing Market, particularly in respect of the 2002 and subsequent underwriting years. The reported position of run-off years of account continues to improve more quickly than anticipated. At financial year-end 2008, there were 37 run-off years open with gross reserves at £2.4 billion. This compares to equivalent values at the end of 2005 of 102 and £7.0 billion, respectively. For the first time in recent memory, 2008 saw a net release (totaling £39 million) of reserves held in respect of run-off liabilities. Syndicates backed by insolvent members supported by the Central Fund reported a small overall surplus again in 2008. These years, however, continue to have the potential to be more problematic. They do not have the same degree of prospective support from positive reserve development to offset continuing although declining negative movements.

**Reinsurance****Table 6****Lloyd's/Reinsurance Usage**

(Mil. £)	2008	2007	2006	2005	2004*	2003	2002
Total gross premiums written	17,985	16,366	16,414	14,982	14,614	16,422	16,203
Total reinsurance ceded	3,768	3,110	3,213	3,212	2,880	4,172	5,043
Total net premiums written	14,217	13,256	13,201	11,770	11,734	12,250	11,160
Reinsurance ceded as % of gross premiums written	21.0	19.0	19.6	21.4	19.7	25.4	31.1
Reinsurers' share of claims outstanding†	10,504	7,449	9,259	14,450	9,678	9,959	12,108
Annual change (%)	41	(20)	(36)	49	(3)	(18)	(16)
Capital and reserves	14,182	13,449	12,836	10,491	11,663	10,145	7,509
Reinsurers' share of claims outstanding as % of capital and reserves†	74.1	55.4	72.1	137.7	83.0	98.2	161.2

\*Restated. †Excludes intersyndicate reinsurance.

The proportion of reinsurance Lloyd's cedes as a percentage of gross premiums written now appears to have stabilized at around 20%, but remains high relative to that of peers. As a result, the Market's competitive position and future earnings remain relatively dependent on the continuing supply of adequate reinsurance capacity. Despite this, we believe Corporation and managing agents' activity has ensured that the Market's reinsurance protection, although significantly reconfigured, is broadly adequate.

Following last year's catastrophe losses, particularly Hurricane Ike, Lloyd's saw a 41% increase to its reinsurance asset at Dec. 31, 2008. Although in our opinion the overall quality of the asset was and remains strong, the sharp increase potentially leaves the Market exposed to reinsurer dispute. Standard & Poor's believes this will continue to be the case following major loss events in the future.

## Financial Flexibility: Diversity Of Capital Providers Positively Differentiates Lloyd's

Table 7

Lloyd's/Capital Requirements And Sources	
Capital requirements	Capital sources
<b>Member/syndicate level</b>	
Underwriting losses	Premium trust funds
Increases in capacity	Members' funds
Changes to ICA/ECA requirements	Cash calls
Liquidity requirements	Outward reinsurance
	Short-term bank facilities
	Parental guarantees
<b>Market level</b>	
Member solvency shortfalls	Central Fund and Corporation assets
Corporation liabilities	Central Fund subordinated loans
	Callable layer
	Centrally raised hybrid equity
	Membership levies

ICA--Individual capital assessment. ECA--Economic capital assessment.

Lloyd's financial flexibility is strong, being principally derived from capital providers' continued support. The diversity of Lloyd's capital providers represents a unique strength for the Market, particularly in the current environment where most (re)insurers are facing significant uncertainty in respect of their ability to raise capital should the need arise. Our view of Lloyd's financial flexibility is also reinforced by the recent completion of Phase II of Equitas' \$7 billion reinsurance deal with NICO, the declining trend of annual undertakings given to insolvent Names, and the positive momentum that continues to surround the Market, which makes Lloyd's an attractive platform for an increasingly diverse range of capital providers.

### Sources

Capital is supplied on the basis of an annual venture, with continuing support from providers needing affirmation each year. As a result, capital providers' continued support, in terms of both willingness and ability, directly or indirectly underpins the majority of Lloyd's capital sources.

The parent companies of corporate members regularly review their Lloyd's exposure, and in some cases such reviews have resulted in complementary operations being established outside the Market. The longevity of any Lloyd's investment will ultimately depend on factors such as: the attractiveness of underwriting conditions; the Lloyd's platform enabling operations to outperform those outside of the Market; the effectiveness of the Corporation in minimizing the cost of mutuality, particularly by reducing any strain on the Central Fund; and regulatory costs (in terms of compliance and the amount of capital held).

In part because most Lloyd's managing agents are not yet in a position to operate meaningfully outside the Market, but largely due to the positive momentum currently surrounding Lloyd's, Standard & Poor's expects the majority of current capital providers to remain committed to Lloyd's in the short to medium term.

**Table 8**

<b>Lloyd's/Financial Flexibility</b>						
<b>(Mil. £)</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>	<b>2004</b>
Market capacity	N.A.	15,954	16,101	14,788	13,722	14,961
Change (%)	N.A.	(1.0)	8.9	7.8	(8.3)	3.9
Annual undertakings to insolvent names granted/(released)	11.0	(14.6)	(14.8)	114.6	217.6	149.5
Change (%)	175.3	1.4	(112.9)	(47.3)	45.6	(19.6)

N.A.--Not available.

Continued diversity within Lloyd's capital base will remain important. Standard & Poor's believes that mutualization would be weakened were underwriting capacity supplied by too few capital providers or if any one provider were to represent too great a proportion of the Market. Concentration of capacity among a few industry investors would mean less incentive to support the Market in the event of a call for extra funds because this could be construed as supporting a competitor.

Since 2004, the Society of Lloyd's has issued subordinated debt to reinforce the central assets available for solvency purposes. For the financial year ended Dec. 31, 2008, these instruments had a face value outstanding of £1.09 billion. In April 2009, the Society repurchased the local currency equivalent of £102 million of its outstanding debt securities at an aggregate discount to face value of approximately 35% thereby crystallizing a gain of about £37 million. Standard & Poor's views this to be an opportunistic trade from Lloyd's perspective, to offer increased liquidity to those debtholders that sought it in a dislocated market. As such, we do not expect that this transaction will hinder Lloyd's future level of access to debt capital markets.

### Needs

Capital needs have declined following Equitas' conclusion of its reinsurance transaction with NICO. Previously, Standard & Poor's had felt that capital providers could be required to support a shortfall scenario at Equitas. In addition, reflecting reducing negative reserve movements in aggregate, annual undertakings given to insolvent members continue to fall. For 2009, these are expected to be at £11 million.

### Ratings Detail (As Of August 11, 2009)\*

#### Operating Company Covered By This Report

#### Lloyd's

Financial Strength Rating

*Local Currency*

A+/Stable/--

#### Domicile

United Kingdom

\*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.

#### Additional Contact:

Insurance Ratings Europe; [Insurancelnteractive\\_Europe@standardandpoors.com](mailto:Insurancelnteractive_Europe@standardandpoors.com)

#### Additional Contact:

Insurance Ratings Europe; [Insurancelnteractive\\_Europe@standardandpoors.com](mailto:Insurancelnteractive_Europe@standardandpoors.com)

Copyright © 2009 by Standard & Poors Financial Services LLC (S&P), a subsidiary of The McGraw-Hill Companies, Inc. All rights reserved. No part of this information may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, without the prior written permission of S&P. S&P, its affiliates, and/or their third-party providers have exclusive proprietary rights in the information, including ratings, credit-related analyses and data, provided herein. This information shall not be used for any unlawful or unauthorized purposes. Neither S&P, nor its affiliates, nor their third-party providers guarantee the accuracy, completeness, timeliness or availability of any information. S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents are not responsible for any errors or omissions, regardless of the cause, or for the results obtained from the use of such information. S&P, ITS AFFILIATES AND THEIR THIRD-PARTY PROVIDERS DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE. In no event shall S&P, its affiliates or their third-party providers and their directors, officers, shareholders, employees or agents be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs) in connection with any use of the information contained herein even if advised of the possibility of such damages.

The ratings and credit-related analyses of S&P and its affiliates and the observations contained herein are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or make any investment decisions. S&P assumes no obligation to update any information following publication. Users of the information contained herein should not rely on any of it in making any investment decision. S&P's opinions and analyses do not address the suitability of any security. S&P does not act as a fiduciary or an investment advisor. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of each of these activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P's Ratings Services business may receive compensation for its ratings and credit-related analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge) and [www.ratingsdirect.com](http://www.ratingsdirect.com) (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

Any Passwords/user IDs issued by S&P to users are single user-dedicated and may ONLY be used by the individual to whom they have been assigned. No sharing of passwords/user IDs and no simultaneous access via the same password/user ID is permitted. To reprint, translate, or use the data or information other than as provided herein, contact Client Services, 55 Water Street, New York, NY 10041; (1)212.438.7280 or by e-mail to: [research\\_request@standardandpoors.com](mailto:research_request@standardandpoors.com).

Copyright © 1994-2009 by Standard & Poors Financial Services LLC, a subsidiary of The McGraw-Hill Companies, Inc. All Rights Reserved.